Jim Hitchner's Valuation Products and Services

VPS Q&A

A free *Q & A* periodical to promote education, build consensus and answer your questions in the financial valuation and litigation services industry.

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Email your question to: jhitchner@valuationproducts.com

S CORP PREMIUMS

Question 1: **Assuming you value an S corp by the income approach and you start by tax affecting the income, what is a general range for an S corp premium (addition to value) when valuing (a) a 100% interest in a company and (b) a minority interest where the distributions only cover the tax burden and that policy is to continue?**

Answer 1: (a) We're *usually* in the 3 percent to 15 percent range, speaking broadly and only of the income approach, but it can depend greatly upon the facts and circumstances, most particularly if there is evidence of C corp buyers in the market. (b) Depends on holding period, and then, who the reasonable pool of buyers are in the market. If short-term hold with subsequent sale to C corp, maybe only 5 or 6 percent . . . if it is long-term, then it could be more, say up to 15 or even 20 percent. Underlying all this, one of the most important, key concepts to bear in mind is that this really isn't a "premium," though we have named it that. Rather, we're adjusting for the fact that we've used a rate of return that doesn't match the cash flow we're valuing.

Answer by: *Nancy Fannon, CPA/ABV, ASA, MCBA, Fannon Valuation Group (Portland, ME) from AICPA BV Conference "Hardball With Hitchner" session and prior communication, author of* <u>Fannon's Guide to Subchapter S Corporation Valuation</u>*, www.fannonval.com nancy@fannonval.com*

DUFF & PHELPS RISK PREMIUMS

Question 2: **Do you use Duff & Phelps equity risk and size premium data or Morningstar (Ibbotson)? Is one better than the other?**

Answer 2: I gave a presentation on Duff & Phelps at the last AICPA BV Conference in New Orleans in December 2007. I also wrote an article "Developing the Cost of Equity: Ibbotson Associates vs. Duff & Phelps" in Issue 4, Dec. 06/Jan. 07 of *Financial Valuation and Litigation Expert,* www.valuationproducts.com. I am a fan of Duff & Phelps because it provides more data than Morningstar and allows for a closer comparison of factors and benchmarks. Duff & Phelps is more flexible. However, I still use Morningstar. I'm not ready to give it up yet, and I still believe it provides useful data.

As I said in my article "Like many analysts, I started out using only the IA [Ibbotson Associates] data to develop an equity discount rate. When the DP [Duff & Phelps] data was first published, I read it primarily out of intellectual curiosity. Then I started using the DP data in my valuations and, for the work done by our firm, I generally found it to be the superior alternative. That being said, the purpose of this article is not to convince anyone to switch; rather, it is to simply high-

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light the pros and cons of each data source from a user perspective . . . I greatly encourage you to do your own investigation so that, given the practical alternatives, you can choose the data source that better fits the facts and circumstances of your particular valuation assignment." Bottom line, most of the analysts I know of who are using Duff & Phelps are still using Morningstar as well. [Rod will address this and other topics as a panelist in the Feb. 27 "Cost of Capital: A Consensus View?" webinar.]

Answer by: *Rod Burkert, CPA/ABV, CVA, MBA, Burkert Valuation Advisors, LLC, (Philadelphia) rod.burkert@burkertvaluation.com*

QMDM ACCEPTANCE

Question 3: **We hear that the Quantitative Marketability Discount Model (QMDM) has not been accepted by the courts or others. Is that true?**

Answer 3: No, it is not true. First off, the QMDM is a shareholder-level discounted cash flow model. The value of an interest in a business is the present value of the expected future benefits of the enterprise that are attributable to the interest discounted to the present at an appropriate discount rate. We at Mercer Capital developed the QMDM in the mid-1990s and have used it in thousands of our reports. Our use of the model has never been successfully challenged, at least yet!

Those who talk about the QMDM's "rejection" by the courts never want to acknowledge that I have presented appraisals to the Tax Court containing the QMDM dating back to the mid 1990s. [*B.W. Thompson,* 72 TCM 1036, Dec. 51, 605(M), TC Memo. 1996-468, *S.H. Marmaduke Est.,* 78 TCM 590, Dec. 53,584(M), TC Memo. 1999-342, and *H.M. Noble Est*., 89 TCM 649, Dec. 55,903(M), TC Memo. 2005-02]. There is not a word of criticism of the QMDM in any of these cases.

Instead, the standard criticism implies that the courts have "repeatedly rejected" the QMDM [citing *E.H. Weinberg* Est., 79 TCM 1507, Dec- 53,753(M), TC Memo. 2000-51; *D.J. Janda,* 81 TCM 1100, Dec.-54,231(M), TC Memo. 2001.24; and *A. Temple*, DC.Tex., 2006.1 USTC ¶60,523, 423 FSupp2d 605 (2006)].

We have addressed every theoretical and practical point about the QMDM in these cases in earlier writings including "The QMDM Fact Sheet," www.mercercapital.com. What is important for readers to note is that in *Weinberg, Janda*, and *Temple,* the courts took issue with the assumptions used in the model, not the model itself. If you or a court disagree with the underlying assumptions used in any discounted cash flow model, the integrity and validity of the valuation method is not impugned.

In discussing the QMDM, many fail to cite *Juan Armstrong v. LaSalle Bank National Association,* No. 05.3417 (7th Cir. May 4, 2006) in which the QMDM was mentioned favorably. The court said it well: "There are techniques for calculating a marketability, or illiquidity, discount, see Z. Christopher Mercer, 'A Primer on the Quantitative Marketability Discount Model,' *CPA Journal*, July 2003, www.nysscpa.org/cpajournal/2003/0703/dept/d076603. htm, visited Apr. 6, 2006, but we shall not speculate on what they might have yielded if applied . . ."

The QMDM is taught or presented by all of the business appraisal professional associations. It is marketed by ValuSource, formerly Wiley-ValuSource, as a standalone software product. It has been presented in both written form and in speeches dozens of times at all the major appraisal professional associations. The professionals of Mercer Capital have presented the application of the model in training sessions to the IRS. It has been subjected to peer review. Four books have been published on the subject, and it is discussed in other leading valuation textbooks.

The QMDM is also an ideal tool to assist business appraisers in meeting the new analytical requirements found in USPAP 2006 Standards Rules 9.4(c) and 9.4(d). Neither the Appraisal Standards Board nor the Appraisal Foundation have endorsed the QMDM or any other model for conducting the new, required analysis of Standards Rules 9-4(c) and 9-4(d). However, it is difficult to see how this new analytical requirement can be met absent the QMDM or similar tools.

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Finally, would you rather defend a marketability discount using the QMDM, where you can make specific assumptions about the expected cash flows pertaining to subject interests and calculate a range of marketability discounts from which to make a final judgment, or would you rather point to tired, stale restricted stock studies with tired, stale transactions, which have been "rejected" by several courts?

Answer by: *Chris Mercer, ASA, CFA, Mercer Capital (Memphis), co-author with Travis Harms of Business Valuation: An Integrated Theory, Second Edition, Wiley Finance and the QMDM Companion, the spreadsheet companion to the QMDM www.mercercapital.com mercerc@mercercapital.com For a fuller explanation see Chris Mercer's article in Issue 11, February/March 2008 Financial Valuation and Litigation Expert journal www.valuationproducts.com*

BV STANDARDS - CALCULATION ENGAGEMENT

Question 4: Given the new AICPA and NACVA standards, how do we deal with the little guy who needs just a few hours of consultation on how to value his or her business? With the new development and reporting standards how do we serve the ultra-small business clientele? We're afraid these people will make ill-fated decisions because they can't afford to pay for the professional standards which we have to comply with. Any guidance would be appreciated.

Answer 4: You can prepare a calculation engagement under *AICPA Statement on Standards for Valuation Services (SSVS)* paragraph 46, a calculation report under paragraphs 48, 73-77 and an oral report under paragraph 78.

Under NACVA's new standards, you can prepare a calculation engagement under sections 2.1, 2.1(b) and 3.1, a calculation report under sections 4.1, 4.3, and 4.3(c), and an oral report under section 4.2.

These requirements are not burdensome and were meant, among other things, to help CPAs and others who choose to comply, provide the services you mentioned. One other suggestion would be to prepare an engagement letter template for these types of engagements that reference the standards and alert the client to what you will and will not do. This would allow greater protection to the provider of the services.

Answer by: *Jim Hitchner, CPA/ABV, ASA, Valuation Products and Services and The Financial Valuation Group (Atlanta), Member of the AICPA BV Standards Writing Task Force for its six year history up to the June 2007 release of the standards. Mr. Hitchner is also the coauthor of VPS's AICPA BV Standards Compliance Toolkit that includes checklists, sample engagement letters and sample reports, www.valuationproducts.com.*